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Southwest Economy

Is Mexico Ready to Roar?

Mexico has become a much more open economy over the past 20 years. And since the 1994 financial crisis, Mexican authorities have shown a commitment to macroeconomic discipline.

Given this progress, many observers are enthusiastic about the country's prospects. Some, in fact, wonder whether Mexico is about to take off and become the world's next economic tiger. The evidence suggests, however, that much work remains to be done before Mexico can catch up to First World nations the way countries such as Singapore and South Korea did in the last few decades.

Until the early 1980s, like most developing nations, Mexico sharply restricted foreign investment and trade in hopes of expanding domestic production capacity. But a severe financial crisis in 1982 prompted a change of tactics. Foreign investment limits were lifted in 1983 in some sectors. In 1985, Mexico announced it would join the General Agreement on Tariffs and Trade and did so the following year. Between 1985 and 1990, the country's maximum tariff fell from 100 percent to 20 percent. Most sectors were opened to foreign investment in 1989, paving the way for a successful wave of privatizations. By 1994, 80 percent of

(Continued on page 2)

Welfare Reform Revisited

In the late 1980s, the number of people receiving welfare benefits in America began to rise. As the trend continued into the 1990s, a bipartisan coalition searched for ways to reform the American welfare system. Convinced that many welfare recipients could work if presented with appropriate incentives, political leaders devised a welfare reform bill that was intended to promote self-sufficiency while retaining a social safety net for those who temporarily have no other options.

The bill was intensely controversial. An influential policy adviser said the bill would inflict "serious injury to American children."[1] A senator who specializes in welfare issues said there was "absolutely no evidence that this radical idea has even the slightest chance of success."[2] And the Center on Budget and Policy Priorities predicted that the most significant effect of welfare reform would be "a large increase in poverty."[3]

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state-owned firms had been privatized. The icing on the cake came in the early 1990s with the implementation of NAFTA, which secured Mexico's access to North American markets.

Mexico's Transformation Triggers Foreign Investment and Trade

This open policy has paid off. Among developing nations today, only China and Brazil receive more foreign investment. In the past 20 years, foreign investment—most of it from the United States—has exploded (*Chart 1*).

Today, firms that receive foreign direct investment account for over 20 percent of all employment in Mexico. Naturally, not all regions have benefited equally. In border states like Chihuahua and Baja California, this employment share exceeds 50 percent. But southern states like Chiapas and Oaxaca have been largely left out. In terms of economic sectors, manufacturing leads in foreign investment, followed by financial services. Within manufacturing, the maquiladora sector accounts for a third of all foreign investment.

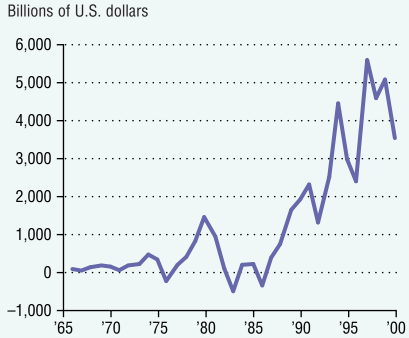
Exports have surged as well. Mexico's exports-to-GDP ratio has tripled since 1980, with manufacturing exports—fueled by foreign investment—accounting for most of the boom (*Chart 2*). Manufactured goods have replaced primary resources as Mexico's main export.

The United States continues to account for the bulk of Mexico's exports and investment inflows. It is the destination of almost 90 percent of Mexico's exports and the source of three-quarters of all foreign investment. As a result, Mexico's economic performance depends more than ever on U.S. economic activity. Between 1994 and 2000, the U.S. expansion enabled Mexico to grow faster than any other Latin American economy. When U.S. manufacturing began slowing in fall 2000, Mexico's six-year expansion ended in synchronicity.

Chart 1

Foreign Investment in Mexico Explodes

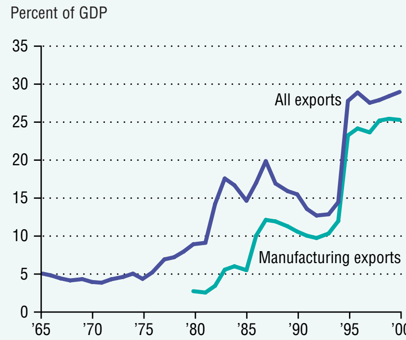
Net U.S. direct investment



SOURCE: Bureau of Economic Analysis.

Chart 2

Mexican Manufacturing Exports Take Off



SOURCES: Banco de México; International Monetary Fund.

Still Not a Success Story

Despite the recent slowdown, Mexico is now Latin America's largest economy in U.S. dollar terms, suggesting that the foreign trade and investment boom is translating into higher economic growth. In light of all the good news, it is tempting to ask whether Mexico is on the brink of becoming the next development success story.

Unfortunately, Mexico's performance since 1994 can't hide the fact that much work remains before it catches up with First World economies. Real GDP per capita almost doubled between 1965 and 1982, and the country was described as an economic miracle. But the downturn in oil prices and a series of financial crises brought the miracle period to an end. Mexico's real GDP per capita today is roughly what it was 20 years ago.

Why haven't the sweeping policy changes of the past 20 years enabled Mexico to pick up where it left off in 1982?

Long-run growth requires an expansion of production capacity. Nations accomplish this by mobilizing more physical and human resources and becoming more productive by, for instance, allocating resources better. Several East Asian countries that were very poor in the 1960s caught up with the industrialized nations in about two generations by doing this. These economic tigers include small countries like Singapore and fairly large ones like South Korea.

Consider South Korea. In 1965, its income per capita was half of Mexico's (*Chart 3*). By the late '80s, however, Korea had overtaken Mexico and is now about twice as rich as its Latin American counterpart. As with the other tigers, Korea experienced an export boom, and its exports-to-GDP ratio has quadrupled since 1970 (*Chart 4*). Manufactured goods accounted for most of the trade expansion, as was the case for all the tigers. In this respect, at least, Mexico does look like a tiger.

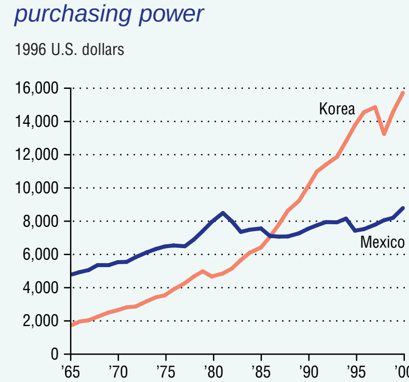
But the key to development, and the area where Mexico falls short, is finding a way to quickly expand production capacity. MIT economist Alwyn Young is credited with establishing that on a basic level, the tigers' economic performance is no mystery.[1] The East Asian tigers, he showed, grew the way they did because they mobilized physical and human resources at a mind-boggling rate.

Again, consider South Korea. Its investment-to-GDP ratio reached almost 40 percent in the late '80s, very high by international standards (*Chart 5*). Interestingly, foreign investment did not play

Chart 3

Korea Overtakes Mexico

Real GDP per capita, adjusted for purchasing power

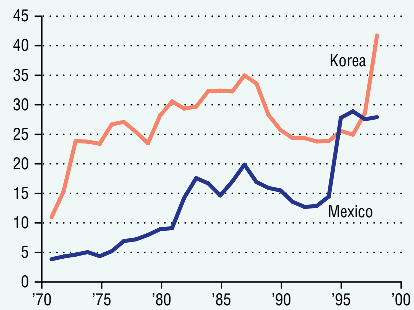


SOURCE: Penn World Tables 6, Organization for Economic Cooperation and Development.

Chart 4

Korea Experiences Export Boom

Percent of GDP



SOURCE: International Monetary Fund.

a big role in this. The investment surge was financed through exceptionally high private and public domestic savings. By contrast, Mexico's investment rate, in spite of the recent influx of foreign money, has hovered around 20 percent for most of the past 30 years.

South Korea's fastest growing resource has been human capital. In 1960, almost half the working population lacked a primary school education (*Chart 6*). Today, 70 percent of working Koreans have at least some secondary education. Mexico's achievements in this area remain dismal. A third of the working population has not completed primary school, and the country today stands roughly where Korea did 40 years ago.

Making a Tiger Out of Mexico

As Nobel Prize economist Robert Lucas once wrote, "If we know what an economic miracle is, we ought to be able to make one." Why can't Mexico replicate what Korea did?

Several factors that contributed to the success of the East Asian tigers may be impossible to replicate. For instance, the savings rates they achieved may not be attainable or even desirable for most emerging nations.

Nevertheless, all developing nations can learn from the East Asian experience. The tigers provided several conditions conducive to the accumulation of physical resources. In most cases, they committed early on to monetary and fiscal discipline and provided predictable macroeconomic conditions for investors. They also provided fairly efficient, stable institutions, such as well-functioning legal systems. As for human capital, the tigers made a major effort to supply basic education and health services during early stages of their catch-up period. Mexico has much work to do in all these areas.

Fiscal Uncertainty

Since its 1994 financial crisis, Mexico has made progress in macroeconomic discipline, bringing inflation down to its lowest in 30 years and fiscal deficits to below 1 percent of GDP. But the government continues to depend on unpredictable oil sales for more than a third of its revenues. The government has been able to trim spending recently, but in the long run, a credible commitment to fiscal and monetary discipline demands that Mexico reduce its dependence on oil revenues. Bond prices plunged recently when Finance Minister Francisco Gil Diaz likened Mexico's fiscal situation to Argentina's. The administration has since tried to reassure financial markets, but Gil Diaz's words struck a sensitive chord.

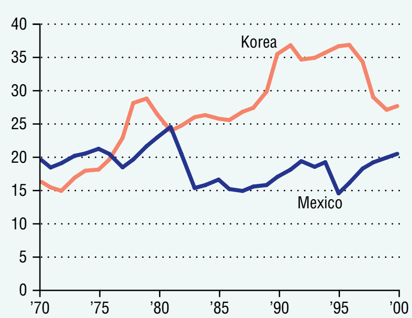
Why is it so difficult for Mexico to find more reliable sources of public revenues? Although tax rates are not low by international standards, many individuals and corporations avoid income taxes altogether, making the tax base small. In Mexico, the informal sector accounts for an amazing 50 percent of employment. As a result, Mexico's tax-to-GDP ratio is markedly below Korea's and the United States'. In fact, it's low even by Latin American standards.

Chart 5

Korea Enjoys Investment Surge

Gross fixed investment

Percent of GDP



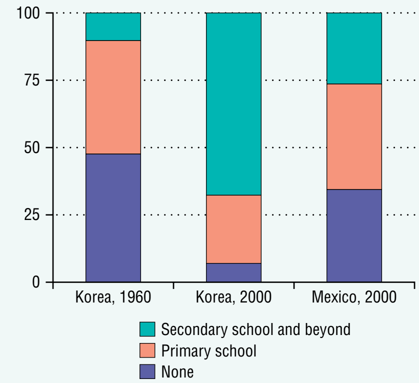
SOURCE: Organization for Economic Cooperation and Development.

Chart 6

Mexico Lags Korea in Education

Educational attainment of working population

Percent



SOURCE: Robert J. Barro and Jong-Wha Lee, "International Data on Educational Attainment," Working Paper no. 42, Center for International Development, Harvard University, April 2000.

Inefficient Institutions

Ill-functioning institutions add to the unpredictability of Mexico's business environment. The biggest problem is that property rights are not effectively enforced because of an inefficient legal system. According to recent estimates, collecting on a bad check takes five times longer in Mexico than in the United States. Resolving more complicated contractual disputes can take several years.

This poor legal environment has many negative consequences. Maybe the most detrimental for growth, and a key reason investment has stagnated, is the impact on the financial sector. Mexican banks are very hesitant to lend in an environment where contracts are not properly enforced. Chart 7 shows the ratio of loans to the private sector to GDP in the past 40 years in Mexico, Korea and the United States. Mexico's financial sector is very small and, if anything, getting smaller. In a recent World Bank survey, over half of Mexican firms described their access to financing as severely limited, compared with 15 percent of U.S. firms. In Singapore (Korea wasn't surveyed), only 10 percent of firms reported that they face the same situation.

To make matters worse, even when they can secure financing, Mexican entrepreneurs face burdensome regulations and a notoriously inefficient bureaucracy.

For example, it takes more than 65 days on average to register a firm in Mexico, compared with four days in the United States.

On the education front, Mexico's poor performance is not due to low spending but to its failure to emphasize basic education. Korea made an early commitment to basic education, and in 1970, two-thirds of the country's educational spending was allocated to preprimary and primary education (*Chart 8*). As recently as 10 years ago, only a third of Mexico's education budget was allocated to preprimary and primary education. This share has increased to one half in recent years, but it will take a generation for these efforts to begin paying off.

The government must find a way to diminish its reliance on oil revenues, perhaps by emphasizing consumption taxation.

Toward Long-Term Growth

So what will it take for Mexico to start growing like a tiger?

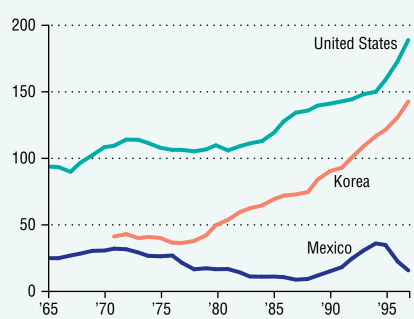
First, the government must find a way to diminish its reliance on oil revenues, perhaps by emphasizing consumption taxation, since income taxation has failed to generate sufficient revenue. Consumption taxation has already shown great potential in Mexico. When a limited value-added tax (VAT) was introduced in 1978, the tax-to-GDP ratio increased by 5 percentage points in two years. President Fox's attempts to expand the VAT base failed last year because he was unable to assuage concerns that the reform would hurt the poor. Increased welfare spending may prove necessary to pass the fiscal reform Mexico needs.[2]

Chart 7

Mexico's Financial Sector Is Small

Loans to private sector

Percent of GDP

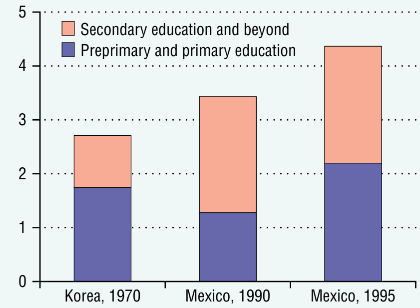


SOURCE: International Monetary Fund.

Chart 8

Mexico Slow to Push Basic Education

Percent of GDP



SOURCES: UNESCO; International Monetary Fund.

Second, Mexico must improve the country's institutions. Mexico can learn from the tigers, which made civil servants' recruitment and promotion merit-based and their pay competitive with the private sector's. As for the judiciary, research suggests that simply devoting more resources to the sector does little to reduce court delays. On the other hand, devoting a larger share of resources to the reduction of procedural times can prove very effective, as Peru demonstrated in 1995.[3]

Third, Mexico must continue fighting its human capital deficit by targeting basic education.

Daunting as they may sound, these are only some of the steps needed to achieve long-term development. As with many other Latin American nations, Mexico direly needs labor market and energy sector reforms. But although much work remains to be done, the potential benefits are enormous.

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Notes

The author thanks Eric Millis for his research assistance.

1 Alwyn Young (1995), "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," *The Quarterly Journal of Economics* (110): August, pp. 641–80.

2 Erwan Quintin (2002), "Mexico's Lawmakers Begin to Confront a Taxing Issue," *The Dallas Morning News*, Jan. 22, p. 27A.

3 Maria Dakolias (1999), "Court Performance Around the World: A Comparative Perspective," World Bank Technical Paper no. 430.